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RR RUEHCHI RUEHDT RUEHHM
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ZNR UUUUU ZZH
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FM AMEMBASSY JAKARTA
TO RUEHC/SECSTATE WASHDC 3636
RUEATRS/DEPT OF TREASURY WASHDC
INFO RUEHZS/ASSOCIATION OF SOUTHEAST ASIAN NATIONS
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEHKO/AMEMBASSY TOKYO 0285
RUEHBJ/AMEMBASSY BEIJING 3872
RUEHBY/AMEMBASSY CANBERRA 0497
RUEHUL/AMEMBASSY SEOUL 3900
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UNCLAS SECTION 01 OF 04 JAKARTA 000653

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DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-SETH SEARLS
COMMERCE FOR 4430/BERLINGUETTE
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO FOR FINEMAN
DEPARTMENT PASS EXIM BANK

E.O. 12598: N/A
TAGS: EFIN EINV ECON PGOV ID
SUBJECT: INDONESIA MACROECONOMY - STRONG 2006 BUT CHALLENGES LOOM IN 2007

A) Jakarta 13326 B) Jakarta 00309 C) Jakarta 00031

¶1. (SBU) Summary. The Government of Indonesia (GOI) successfully restored macroeconomic stability in 2006, implementing prudent monetary and fiscal policies and paving the way for a rebound in gross domestic product (GDP) growth. These policies contributed to stable prices, a strong currency, lower public debt and increased investor confidence. Real GDP growth rose to 6.1% on a year-on-year (YoY) basis during the final quarter of 2006, boosting GDP growth for the full year to 5.5% (YoY). Although exports rose strongly during the year, employment growth lagged in large part due to limited growth in labor-intensive manufacturing. Most analysts expect Indonesia's cyclical economic recovery to continue in 2007, with increases in domestic demand and investment, but risks to longer term stability and sustained growth have increased. Growth in net exports, the primary driver of GDP growth in 2006, is likely to slow in 2007, in response to a likely flattening out of world commodity prices and increased demand for imports. Despite a strong GOI budget position, very slow progress on the GOI's infrastructure policy initiatives make the outlook for a significant increase in infrastructure spending in 2007 poor. The GOI's key medium term challenge will be finding ways to boost growth after the current cyclical upswing begins to wane or if the international economic environment turns less supportive. Ramping up anti-poverty spending in 2008-09 may be the GOI's best bet. End summary.

Table 1: 2006 Real GDP Growth, Year-on-Year

	Q1	Q2	Q3	Q4	Full Year
Private Consumption	3.2	3.0	3.0	3.8	3.2
Government Consumption	14.2	31.6	1.8	2.2	9.6
Fixed Capital Formation	2.9	-1.0	-0.3	8.2	2.9
Exports of Goods and Services	10.8	11.3	12.1	6.1	9.2
Imports of Goods and Services	5.0	8.3	9.7	9.7	7.6

GDP	4.6	5.2	5.5	6.1	5.5

Source: Central Bureau of Statistics

Macroeconomic Stability Returns in 2006

¶2. (SBU) 2006 was a good year for the Indonesian economy. The GOI and BI took effective action to restore macroeconomic stability during the year by implementing prudent monetary and fiscal policies. In addition to slowly easing rates in 2006 in line with lower inflationary expectations, BI issued a series of policy statements signaling an independent and prudent approach to monetary policy. The GOI ran a cautious fiscal policy during the year, with the budget deficit remaining close to 1% of GDP. As Table 1 indicates, YoY GDP growth rates accelerated in four consecutive quarters during the year largely in response to the stable macroeconomic environment.

¶3. (U) Prudent GOI policies also contributed to stable prices, a strong rupiah, lower public debt and increased investor confidence. After climbing to 17.1% in 2005 due to the October 2005 fuel subsidy cuts, Indonesia's YoY headline inflation rate slowed again in 2006, ending the year at 6.6%. The rupiah/USD exchange rate remained in the 9000-9200 range for most of 2006, recovering from a low of approximately Rp 11,000/USD in August 2005. The public debt to GDP ratio continued to decline in 2006 to about 35%, down from 54% in ¶2004. Rating agencies also signaled renewed confidence in the Indonesian economy, with both Fitch and Moody's moving their sovereign debt outlook from stable to positive. Portfolio investment continued to flow to Indonesia in 2006 driving the market capitalization of the Jakarta Stock Exchange up 55.6% (YoY) and the

risk premium on Indonesian debt down to roughly 100 basis points. Foreign exchange reserves grew by $7.4 billion during the year to $42.6 billion at the end of December, despite Indonesia's early repayment of $6.9 billion in IMF loans.

¶4. (SBU) After falling below 5.0% during the first quarter of 2006, real GDP growth rebounded to 6.1% (YoY) during the final quarter of the year, boosting GDP growth for all of 2006 to 5.5% (YoY). A strong expansion in commodity exports was the primary driver of growth during the year (Ref B). A moderate increase in domestic demand and the almost 10% growth (YoY) in government spending also supported GDP expansion. Although the pace of domestic investment growth improved in the fourth quarter of 2004, expanding 8.3%(YoY), investment growth remained below 3.0% (YoY) during the full year 2006, in contrast to 14.1% (YoY) and 9.9% growth (YoY) in 2004 and 2005, respectively. (Note: Indonesia's official investment statistics may understate investment growth due to difficulties in compiling statistics. Actual investment growth in 2006 may have been closer to the rate of growth of GDP. End note.)

Table 2: 2006 GDP Growth by Industry (percent)

	Growth Rate	Share GDP Grow.
Agriculture/Livestock/Forestry and Fishery	3.0	7.3
Mining and Quarrying	2.2	3.6
Manufacturing	4.6	23.6
Electricity/Gas/Water	5.9	1.8
Construction	9.0	9.1
Trade/Hotel/Restaurant	6.1	18.2
Transport/Communication	13.6	16.4
Financial/Bus. Service	5.7	9.1
Services	6.2	10.9
GDP	5.5	100.0

Note: Share of GDP Growth (Share GDP Grow.)
Source: Central Bureau of Statistics

¶5. (SBU) The most vibrant industries in the economy in 2006 were transportation/communications and construction, which grew 13.6% and 9.0% (YoY), respectively. Growth in these sectors comprised a combined 25% of overall GDP growth. Manufacturing growth, which comprises the largest single industrial component of the GDP, expanded a modest 4.6 percent in 2006, contributing slightly less to growth than transportation/communications and construction combined. Growth in financial and business services as well as trade, hotel and restaurant services was moderate, but growth in those industries contributed a combined 35% of overall GDP growth.

¶6. (SBU) Despite accelerating growth during the year, Indonesia's open unemployment rate barely budged, remaining at about 10.3%. Most analysts believe lagging growth in labor-intensive agriculture and manufacturing industries is to blame for Indonesia's stubborn unemployment problem. Despite several policy packages designed to improve the climate for investment, excessive red tape (especially relating to customs clearance and taxation), corruption, and limited access to capital continue to hold back growth in the manufacturing sector.

Investment and Household Demand to Rise in 2007

¶7. (SBU) Most analysts expect a modest increase in domestic demand and investment during 2007, in line with Indonesia's current cyclical economic recovery. Indicators of strengthening domestic demand include rising non-oil imports, faster expansion of domestic credit, and improved auto sales. Non-oil imports grew almost 20% YoY in January 2007. After growing less than 3% during the first half of the year, domestic credit expansion accelerated during the fourth quarter of 2006, bringing the YoY growth in credit for 2006 to 10.7% on a nominal basis. After rising to a record 50,000 a month in August 2005, monthly auto sales plummeted to an average of roughly 25,000 a month from November 2005 to October 2006. However,

beginning in November 2006, auto sales began to slowly recover, averaging 32,200 a month during the final two months of 2006. Yet not all indicators of domestic demand point to stronger growth. BI's consumer confidence index declined in January 2007 for the second consecutive month due to increased pessimism over job availability and decreased optimism about the future direction of economic conditions and wage rates.

¶8. (U) Observers expect overall investment to continue to recover during at least the first half of 2007, again in line with Indonesia's cyclical recovery. In line with this expectation, capital goods imports doubled from October to November 2006, jumping from $500 million to $1 billion. Capital goods imports were roughly $700 million per month in December and January 2006. Moreover, BI's fourth quarter 2006 Business Survey, 27.5% of respondents plan to increase investment in the first half of 2007, compared to 26.6% during the latter half of 2006.

Infrastructure Spending Still Very Slow

¶9. (SBU) Despite a strong GOI budget position and several ongoing infrastructure policy initiatives, the outlook for a significant increase in infrastructure spending in 2007 appears poor. Increasing infrastructure investment is important to relieve transportation bottlenecks that are raising the cost of producing goods in Indonesia, and also because of the positive impact on aggregate demand of large infrastructure projects. World Bank and Asian Development Bank infrastructure experts are growing increasingly pessimistic about the pace of infrastructure projects in the GOI pipeline. They cite extremely poor coordination among GOI infrastructure ministries, complicated legal processes necessary to implement infrastructure projects, political interference, and continuing corruption as critical problems impeding progress on infrastructure investment. They note that under the current system, the time required to move from tendering to financial closing for most projects is roughly two years.

¶10. (SBU) The continuing slowness in infrastructure development is leading the World Bank, ADB, and other institutions to rethink the GOI's heavy reliance on private-public partnerships to attract capital to the infrastructure sector. Instead, they are recommending the GOI consider financing more infrastructure projects directly from the budget or through consortia of state-owned companies and state-owned banks.

Slowing Export Growth Raises Risks

¶11. (U) Most economists in the region expect growth in global commodity prices to moderate in 2007, in line with slower growth across the United States and other developed countries. In addition, capital goods imports are likely to increase in 2007 in line with Indonesia's cyclical recovery. As a result, growth in net exports, the primary driver of GDP growth in 2006, is likely to slow in 2007. While few predict a major slowdown in commodity exports over the next twelve months, a significant decline in commodity prices could have a destabilizing effect on the economy, particularly in the context of weak manufactured goods exports. A significant contraction in net exports could put pressure on Indonesia's currency and balance of payments, with a possible negative impact on Indonesia's risk premium.

¶12. (SBU) Perhaps chastened by the August 2005 rupiah "mini-crisis," BI has signaled it will move cautiously on monetary policy in 2007. In its most recent press release on monetary policy, BI stated that it intends to "proceed more carefully in the timing and magnitude of changes in the BI rate to maintain existing price and exchange rate stability." According to BI staff, concerns that excessive domestic demand could reignite inflation and possibly macroeconomic instability in light of the significant supply side constraints facing Indonesia are driving this cautious stance. As a result, BI is likely to slow the rate of interest rate cuts in the absence of significant efforts on the part of the government to improve Indonesia's infrastructure and investment climate and/or significant growth in fixed capital investment in Indonesia.

Budget Deficit to Rise Modestly

¶13. (SBU) The GOI's October 2005 fuel subsidy cuts, which trimmed subsidy spending that had reached over 3% of GDP in 2005, have provided an estimate $10-15 billion of fiscal space for the GOI to spend on other priorities. Education and health has already increased dramatically, but as noted above, spending on large scale infrastructure projects has yet to accelerate. The central government now distributes approximately one third of the national budget to local governments. However, according to World Bank staff, only 40% of local governments actually have a quantified budget, while even fewer have the resources necessary to manage public spending programs. As a result, a large number of local governments have been slow to spend their newly expanded resources, opting instead to deposit the funds in local banks. While most observers expect central and local spending to rise in 2007, many doubt that the government will be able to overcome the significant bureaucratic hurdles needed to ramp up infrastructure spending.

Comment: What About 2008?

¶14. (SBU) The SBY administration and BI are unlikely to depart from their prudent monetary and fiscal policy stance in 2007, and most analysts expect a very good year in 2007, with growth possibly approaching seven percent. But given the important role of export growth as a driver of Indonesia's recent economic performance, Indonesia's medium term growth prospects are cloudier, especially if the external economic environment turns less supportive. In this case, to maintain high growth rates, Indonesia would need to expand government consumption and investment, neither of which is an easy task. Inducing more private investment would require finding a way to advance stalled reforms on important investment climate issues

like corruption, tax, customs, and labor issues. And with few large infrastructure projects yet out of the gate, it is difficult to see much infrastructure-led growth occurring before 2009. The GOI's best hope to deliver more growth after 2007 may be to expand aggressively several anti-poverty programs it is scheduled to roll out in 2008-09. If the GOI can channel enough funds through these programs to villages and poorer Indonesians, it could make for a much more supportive macroeconomic (and political) environment for the next election cycle in 2009.

PASCOE